to be allocated equals $52,250 ($56,000 minus the $3,750 of state F income tax specifically allocated to foreign source portfolio dividends). P allocates this portion by applying the methodology illustrated in paragraph (ii) of Example 25, as modified by paragraph (e)(6)(ii)(D)(*3*)(*iii*) of this section. Thus, P compares its adjusted state taxable income (as determined under Step One in paragraph (A) above) with its adjusted U.S. source federal taxable income (as determined under Step Two in paragraph (B) above). Because P's adjusted state taxable income ($762,500) exceeds P's adjusted U.S. source federal taxable income ($450,000), the remaining portion of P's deduction for state income tax ($52,500) must be allocated to a class of gross income that includes both U.S. and foreign source income.

(D) *Step Four—Apportionment.* P must apportion to U.S. source income the portion of the deduction that is attributable to state income tax imposed upon state taxable income in an amount equal to P's adjusted U.S. source federal taxable income.

Amount of deduction to be apportioned	$52,250.00
Less portion of deduction initially apportioned to income from sources within the United States (residual grouping): $52,250×($450,000/$762,500)	30,836.07
Remainder requiring further apportionment: $52,250×($312,500/$762,500)	21,413.93

The remainder of $21,413.93 must be further apportioned between foreign source general limitation income and U.S. source federal taxable income in the same proportions that P's adjusted U.S. source federal taxable income and foreign source general limitation income bear to P's total federal taxable income (taking into account the adjustment of U.S. source federal taxable income and reduced by the amount of foreign source portfolio dividends to which the tax has been specifically allocated).

Portion of remainder apportioned to foreign source general limitation income (statutory grouping): $21,413.93 X ($212,500/$662,500)	$6,868.62
Remaining state income tax deduction to be apportioned to income from sources within the United States (residual grouping): $21,413.93 X ($450,000/$662,500)	$14,545.31

Of P's total deduction of $56,000 for state income tax, the portion allocated and apportioned to foreign source general limitation income equals $10,618.62—the sum of $6,868.62 apportioned under Step Four and the $3,750.00 specifically allocated to foreign source portfolio dividend income under Step One. The portion of the deduction allocated and apportioned to U.S. source income equals $45,381.38—the sum of the $30,836.07 and the $14,545.31 apportioned under Step Four.

(h) *Effective/applicability date.* Paragraphs (f)(1)(vi)(E), (f)(1)(vi)(F), and (f)(1)(vi)(H) of this section apply to taxable years ending after April 9, 2008.

[T.D. 7456, 42 FR 1195, Jan. 6, 1977]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.861–8, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.

§ 1.861–8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

(a) *In general.* (1) [Reserved]

(2) *Allocation and apportionment of deductions in general.* If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income, except to the extent that expenses, losses, and other deductions are allocated and apportioned as if all domestic members of an affiliated group were a single corporation under section 864(e) and the regulations thereunder. See § 1.861–9T through § 1.861–11T for rules regarding the affiliated group allocation and apportionment of interest expense, and § 1.861–14T for rules regarding the affiliated group allocation and apportionment of expenses other than interest.

(3)–(5)(i) [Reserved]

(ii) Paragraph (e)(4), the last sentence of paragraph (f)(4)(i), and paragraph (g), *Example 17*, *Example 18*, and *Example 30* of this section are generally applicable for taxable years beginning after December 31, 2006. In addition, a person may elect to apply the provisions of paragraph (e)(4) of this section to earlier years. Such election shall be made in accordance with the rules set forth in § 1.482–9T(n)(2).

(b) *Allocation.* (1)–(2) [Reserved]

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it

would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated or could reasonably be expected to generate gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) to expenses other than expenses attributable to stewardship activities, see *Examples 19* through *21* of paragraph (g) of this section. See paragraph (e)(4)(ii) of this section for the allocation and apportionment of deductions attributable to stewardship expenses. However, supportive deductions that are described in §1.861–14T(e)(3) shall be allocated and apportioned in accordance with the rules of §1.861–14T and shall not be allocated and apportioned by reference only to the gross income of a single member of an affiliated group of corporations as defined in §1.861–14T(d).

(4)–(5) [Reserved]

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. Thus, in determining the separate limitations on the foreign tax credit imposed by section 904(d)(1) or by section 907, the income within a separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual grouping. In this regard, the same method of apportionment must be used in apportioning a deduction to each separate limitation category. Also, see paragraph (f)(1)(iii) of this section with respect to the apportionment of deductions among the statutory groupings designated in section 904(d)(1). If the class of gross income to which a deduction has been allocated consists entirely of a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in one or more statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which deductions exceed gross income. In determining the method of apportionment for a specific deduction, examples of bases and factors which should be considered include, but are not limited to—

(i) Comparison of units sold,

(ii) Comparison of the amount of gross sales or receipts,

(iii) Comparison of costs of goods sold,

(iv) Comparison of profit contribution,

(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income, and

(iv) Comparison of the amount of gross income.

Paragraph (e) (2) through (8) of this section provides the applicable rules for allocation and apportionment of deductions for interest, research and development expenses, and certain other deductions. The effects on tax liability of the apportionment of deductions and the burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application are sufficiently precise. A method of apportionment described in this paragraph (c)(1) may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. Furthermore, certain methods of apportionment described in this paragraph (c)(1) may not be used in connection with any deduction for which another method is prescribed. The principles set forth above are applicable in apportioning both deductions definitely related to a class which constitutes less than all of the taxpayer's gross income and to deductions related to all of the taxpayer's gross income. If a deduction is not related to any class of gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section.

(2) *Apportionment based on assets.* Certain taxpayers are required by paragraph (e)(2) of this section and §1.861–9T to apportion interest expense on the basis of assets. A taxpayer may apportion other deductions based on the comparative value of assets that generate income within each grouping, provided that such method reflects the factual relationship between the deduction and the groupings of income and is applied in accordance with the rules of §1.861–9T(g). In general, such apportionments must be made either on the basis of the tax book value of those assets or on their fair market value. However, once the taxpayer uses fair market value, the taxpayer and all related persons must continue to use such method unless expressly authorized by the Commissioner to change methods. For purposes of this paragraph (c)(2) the term *related persons* means two or more persons in a relationship described in section 267(b). In determining whether two or more corporations are members of same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned by the application of section 267(c). In determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3). In the case of any corporate taxpayer that—

(i) Uses tax book value, and

(ii) Owns directly or indirectly (within the meaning of §1.861–11T(b)(2)(ii)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote in any other corporation (domestic or foreign) that is not a member of the affiliated group (as defined in section 864(e)(5)), such taxpayer shall adjust its basis in that stock in the manner described in §1.861–11T(b).

(3) [Reserved]

(d) *Excess of deductions and excluded and eliminated items of income.* (1) [Reserved]

(2) *Allocation and apportionment to exempt, excluded or eliminated income*—(i) *In general.* In the case of taxable years beginning after December 31, 1986, except to the extent otherwise permitted by §1.861–13T, the following rules shall apply to take account of income that is exempt or excluded, or assets generating such income, with respect to allocation and apportionment of deductions.

(A) *Allocation of deductions.* In allocating deductions that are definitely related to one or more classes of gross income, exempt income (as defined in paragraph (d)(2)(ii) of this section) shall be taken into account.

(B) *Apportionment of deductions.* In apportioning deductions that are definitely related either to a class of gross income consisting of multiple groupings of income (whether statutory or residual) or to all gross income, exempt income and exempt assets (as defined in paragraph (d)(2)(ii) of this section) shall not be taken into account.

For purposes of apportioning deductions which are not taken into account under § 1.1502–13 in determining gain or loss from intercompany transactions, as defined in § 1.1502–13, income from such transactions shall be taken into account in the year such income is ultimately included in gross income.

(ii) *Exempt income and exempt asset defined*—(A) *In general.* For purposes of this section, the term *exempt income* means any income that is, in whole or in part, exempt, excluded, or eliminated for federal income tax purposes. The term *exempt asset* means any asset the income from which is, in whole or in part, exempt, excluded, or eliminated for federal tax purposes.

(B) *Certain stock and dividends.* The term ''exempt income'' includes the portion of the dividends that are deductible under—

(*1*) Section 243(a) (1) or (2) (relating to the dividends received deduction),

(*2*) Section 245(a) (relating to the dividends received deduction for dividends from certain foreign corporations).

Thus, for purposes of apportioning deductions using a gross income method, gross income would not include a dividend to the extent that it gives rise to a dividend received deduction under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of a life insurance company taxable under section 801, the amount of such stock that is treated as tax exempt shall not be reduced because a portion of the dividends received deduction is disallowed as attributable to the policyholder's share of such dividends. See § 1.861–14T(h) for a special rule concerning the allocation of reserve expenses of a life insurance company. In addition, for purposes of apportioning deductions using an asset method, assets would not include that portion of stock equal to the portion of dividends paid thereon that would be deductible under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), such stock shall not constitute a tax exempt asset. Such stock and the dividends thereon will, however, be eliminated from consideration in the apportionment of interest expense under the consolidation rule set forth in § 1.861–10T(c), and in the apportionment of other expenses under the consolidation rules set forth in § 1.861–14T.

(iii) *Income that is not considered tax exempt.* The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:

(A) In the case of a foreign taxpayer (including a foreign sales corporation (FSC)) computing its effectively connected income, gross income (whether domestic or foreign source) which is not effectively connected to the conduct of a United States trade or business;

(B) In computing the combined taxable income of a DISC or FSC and its related supplier, the gross income of a DISC or a FSC;

(C) For all purposes under subchapter N of the Code, including the computation of combined taxable income of a possessions corporation and its affiliates under section 936(h), the gross income of a possessions corporation for which a credit is allowed under section 936(a); and

(D) Foreign earned income as defined in section 911 and the regulations thereunder (however, the rules of § 1.911–6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)).

(iv) *Prior years.* For expense allocation and apportionment rules applicable to taxable years beginning before January 1, 1987, and for later years to the extent permitted by § 1.861–13T, see § 1.861–8(d)(2) (Revised as of April 1, 1986).

(e) *Allocation and apportionment of certain deductions.* (1) [Reserved]. For further guidance, see § 1.861–8(e)(1).

(2) *Interest.* The rules concerning the allocation and apportionment of interest expense and certain interest equivalents are set forth in §§ 1.861–9T through § 1.861–13T.

(3)–(11) [Reserved]. For further guidance, see § 1.861–8(e)(3) through (e)(11).

(4) *Stewardship and controlled services*—(i) *Expenses attributable to controlled services.* If a corporation performs a controlled services transaction (as defined in § 1.482–9T(l)(3)), which includes any activity by one member of a group of controlled taxpayers that results in a benefit to a related corporation, and the rendering corporation charges the related corporation for such services, section 482 and these regulations provide for an allocation where the charge is not consistent with an arm's length result as determined. The deductions for expenses of the corporation attributable to the controlled services transaction are considered definitely related to the amounts so charged and are to be allocated to such amounts.

(ii) *Stewardship expenses attributable to dividends received.* Stewardship expenses, which result from ''overseeing'' functions undertaken for a corporation's own benefit as an investor in a related corporation, shall be considered definitely related and allocable to dividends received, or to be received, from the related corporation. For purposes of this section, stewardship expenses of a corporation are those expenses resulting from ''duplicative activities'' (as defined in § 1.482–9T(l)(3)(iii)) or ''shareholder activities'' (as defined in § 1.482–9T(l)(3)(iv)) of the corporation with respect to the related corporation. Thus, for example, stewardship expenses include expenses of an activity the sole effect of which is either to protect the corporation's capital investment in the related corporation or to facilitate compliance by the corporation with reporting, legal, or regulatory requirements applicable specifically to the corporation, or both. If a corporation has a foreign or international department which exercises overseeing functions with respect to related foreign corporations and, in addition, the department performs other functions that generate other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations, foreign-source royalties, and gross income of foreign branches), some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also generate United States source income (such as fees for services performed in the United States). Permissible methods of apportionment with respect to stewardship expenses include comparisons of time spent by employees weighted to take into account differences in compensation, or comparisons of each related corporation's gross receipts, gross income, or unit sales volume, assuming that stewardship activities are not substantially disproportionate to such factors. See paragraph (f)(5) of this section for the type of verification that may be required in this respect. See § 1.482–9T(l)(5) for examples that illustrate the principles of § 1.482–9T(l)(3). See *Example 17* and *Example 18* of paragraph (g) of this section for the allocation and apportionment of stewardship expenses. See paragraph (b)(3) of this section for the allocation and apportionment of deductions attributable to supportive functions other than stewardship expenses, such as expenses in the nature of day-to-day management, and paragraph (e)(5) of this section generally for the allocation and apportionment of deductions attributable to legal and accounting fees and expenses.

(f) *Miscellaneous matters*—(1) *Operative sections.* (i) [Reserved]

(ii) *Separate limitations to the foreign tax credit.* Section 904(d)(1) requires that the foreign tax credit limitation be determined separately in the case of the types of income specified therein. Accordingly, the income within each separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual groups.

(iii) [Reserved]

(2)–(3) [Reserved]

(4) *Adjustments made under other provisions of the Code*—(i) *In general.* If an adjustment which affects the taxpayer is made under section 482 or any other provision of the Code, it may be necessary to recompute the allocations and apportionments required by this

section in order to reflect changes resulting from the adjustment. The recomputation made by the Commissioner shall be made using the same method of allocation and apportionment as was originally used by the taxpayer, provided such method as originally used conformed with paragraph (a)(5) of this section and, in light of the adjustment, such method does not result in a material distortion. In addition to adjustments which would be made aside from this section, adjustments to the taxpayer's income and deductions which would not otherwise be made may be required before applying this section in order to prevent a distortion in determining taxable income from a particular source of activity. For example, if an item included as a part of the cost of goods sold has been improperly attributed to specific sales, and, as a result, gross income under one of the operative sections referred to in paragraph (f)(1) of this section is improperly determined, it may be necessary for the Commissioner to make an adjustment to the cost of goods sold, consistent with the principles of this section, before applying this section. Similarly, if a domestic corporation transfers the stock in its foreign subsidiaries to a domestic subsidiary and the parent corporation continues to incur expenses in connection with protecting its capital investment in the foreign subsidiaries (see paragraph (e)(4) of this section), it may be necessary for the Commissioner to make an allocation under section 482 with respect to such expenses before making allocations and apportionments required by this section, even though the section 482 allocation might not otherwise be made.

(5) [Reserved]

(g) [Reserved]

Examples 1–16. [Reserved]

Example 17. Stewardship Expenses (Consolidation). (i) (A) *Facts.* X, a domestic corporation, wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is general limitation income from sources within South America, and all of N's income is general limitation income from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000 as follows:

	Gross income	Deductions
Corporations:		
X	$100,000	$50,000
M	250,000	100,000
N	150,000	200,000
O	50,000	20,000
Total	550,000	370,000

(B) Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the sole effect of the entire $30,000 of deductions is to protect X's capital investment in M, N, and O. X properly categorizes the $30,000 of deductions as stewardship expenses. The remainder of X's deductions ($20,000) relates to production of United States source income from its plant in the United States.

(ii) (A) *Allocation.* X's deductions of $50,000 are definitely related and thus allocable to the types of gross income to which they give rise, namely $25,000 wholly to general limitation income from sources outside the United States ($15,000 for stewardship of M and $10,000 for stewardship of N) and the remainder ($25,000) wholly to gross income from sources within the United States. Expenses incurred by M and N are entirely related and thus wholly allocable to general limitation income earned from sources without the United States, and expenses incurred by O are entirely related and thus wholly allocable to income earned within the United States. Hence, no apportionment of expenses of X, M, N, or O is necessary. For purposes of applying the foreign tax credit limitation; the statutory grouping is general limitation gross income from sources without the United States and the residual grouping is gross income from sources within the United States. As a result of the allocation of deductions, the X consolidated group has taxable income from sources without the United States in the amount of $75,000, computed as follows:

Foreign source general limitation gross income:	
($250,000 from M + $150,000 from N)	$400,000
Less: Deductions allocable to foreign source general limitation gross income:	
($25,000 from X, $100,000 from M, and $200,000 from N)	325,000
Total foreign-source taxable income	75,000

(B) Thus, in the combined computation of the general limitation, the numerator of the limiting fraction (taxable income from sources outside the United States) is $75,000.

Example 18. Stewardship and Supportive Expenses. (i) (A) *Facts.* X, a domestic corporation, manufactures and sells pharmaceuticals in the United States. X's domestic subsidiary S, and X's foreign subsidiaries T, U, and V perform similar functions in the United States and foreign countries T, U, and V, respectively. Each corporation derives substantial net income during the taxable year that is general limitation income described in section 904(d)(1). X's gross income for the taxable year consists of:

Domestic sales income	$32,000,000
Dividends from S (before dividends received deduction)	3,000,000
Dividends from T	2,000,000
Dividends from U	1,000,000
Dividends from V	0
Royalties from T and U	1,000,000
Fees from U for services performed by X	1,000,000
Total gross income	40,000,000

(B) In addition, X incurs expenses of its supervision department of $1,500,000.

(C) X's supervision department (the Department) is responsible for the supervision of its four subsidiaries and for rendering certain services to the subsidiaries, and this Department provides all the supportive functions necessary for X's foreign activities. The Department performs three principal types of activities. The first type consists of services for the direct benefit of U for which a fee is paid by U to X. The cost of the services for U is $900,000 (which results in a total charge to U of $1,000,000). The second type consists of activities described in §1.482–9(l)(3)(iii) that are in the nature of shareholder oversight that duplicate functions performed by the subsidiaries' own employees and that do not provide an additional benefit to the subsidiaries. For example, a team of auditors from X's accounting department periodically audits the subsidiaries' books and prepares internal reports for use by X's management. Similarly, X's treasurer periodically reviews for the board of directors of X the subsidiaries' financial policies. These activities do not provide an additional benefit to the related corporations. The cost of the duplicative services and related supportive expenses is $540,000. The third type of activity consists of providing services which are ancillary to the license agreements which X maintains with subsidiaries T and U. The cost of the ancillary services is $60,000.

(ii) *Allocation.* The Department's outlay of $900,000 for services rendered for the benefit of U is allocated to the $1,000,000 in fees paid by U. The remaining $600,000 in the Department's deductions are definitely related to the types of gross income to which they give rise, namely dividends from subsidiaries S, T, U, and V and royalties from T and U. However, $60,000 of the $600,000 in deductions are found to be attributable to the ancillary services and are definitely related (and therefore allocable) solely to royalties received from T and U, while the remaining $540,000 in deductions are definitely related (and therefore allocable) to dividends received from all the subsidiaries.

(iii) (A) *Apportionment.* For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of $540,000 for the Department's expenses and related supportive expenses which are allocable to dividends received from the subsidiaries must be apportioned between the statutory and residual groupings before the foreign tax credit limitation may be applied. In determining an appropriate method for apportioning the $540,000, a basis other than X's gross income must be used since the dividend payment policies of the subsidiaries bear no relationship either to the activities of the Department or to the amount of income earned by each subsidiary. This is evidenced by the fact that V paid no dividends during the year, whereas S, T, and U paid dividends of $1 million or more each. In the absence of facts that would indicate a material distortion resulting from the use of such method, the stewardship expenses ($540,000) may be apportioned on the basis of the gross receipts of each subsidiary.

(B) The gross receipts of the subsidiaries were as follows:

S	$4,000,000
T	3,000,000
U	500,000
V	1,500,000
Total	9,000,000

(C) Thus, the expenses of the Department are apportioned for purposes of the foreign tax credit limitation as follows:

Apportionment of stewardship expenses to the statutory grouping of gross income: $540,000 × [($3,000,000 + $500,000 + $1,500,000)/$9,000,000]	$300,000
Apportionment of supervisory expenses to the residual grouping of gross income: $540,000 × [$4,000,000/9,000,000]	240,000
Total: Apportioned stewardship expense	540,000

Examples 19–23. [Reserved]

Example 24. Exempt, excluded, or eliminated income. (i) *Income method*—(A) *Facts.* X, a domestic corporation organized on January 1, 1987, is engaged in a number of businesses worldwide. X owns a 25-percent voting interest in each of five corporations engaged in the business A, two of which are domestic and three of which are foreign. X incurs stewardship expenses in connection with these five stock investments in the amount of $100. X apportions its stewardship expenses using a gross income method. Each of the five companies pays a dividend in the amount of $100. X is entitled to claim the 80-percent dividends received deduction on dividends paid by the two domestic companies. Because tax exempt income is considered in the allocation of deductions, X's $100 stewardship expense is allocated to the class of income consisting of dividends from business A companies. However, because tax exempt income is not considered in the apportionment of deductions within a class of gross income, the gross income of the two domestic companies must be reduced to reflect the availability of the dividends received deduction. Thus, for purposes of apportionment, the gross income paid by the three foreign companies is considered to be $100 each, while the gross income paid by the domestic companies is considered to be $20 each. Accordingly, X has total gross income from business A companies, for purposes of apportionment, of $340. As a result, $29.41 of X's stewardship expense is apportioned to each of the foreign companies and $5.88 of X's stewardship expense is apportioned to each of the domestic companies.

(ii) *Asset method*—(A) *Facts.* X, a domestic corporation organized on January 1, 1987, carries on a trade or business in the United States. X has deductible interest expense incurred in 1987 of $60,000. X owns all the stock of Y, a foreign corporation. X also owns 49 percent of the voting stock of Z, a domestic corporation. Neither Y nor Z has retained earnings and profits at the end of 1987. X apportions its interest expense on the basis of the fair market value of its assets. X has assets worth $1,500,000 that generate domestic source income, among which are tax exempt municipal bonds worth $100,000, and the stock of Z, which has a value of $500,000. The Y stock owned by X has a fair market value of $2,000,000 and generates solely foreign source general limitation income.

(B) *Allocation.* No portion of X's interest expense is directly allocable solely to identified property within the meaning of §1.861–10T. Thus, X's deduction for interest is definitely related to all its gross income as a class.

(C) *Apportionment.* For purposes of apportioning expenses, assets that generate exempt, eliminated, or excluded income are not taken into account. Because X's municipal bonds are tax exempt, they are not taken into account in apportioning interest expense. Since X is entitled to claim under section 243 to 80-percent dividends received deduction with respect to the dividend it received from Z, 80 percent of the value of that stock is not taken into account as an asset for purposes of apportionment under the asset method. X apportions its interest deduction between the statutory grouping of foreign source general limitation income and the residual grouping of domestic source income as follows:

To foreign source general limitation income:

$$\text{Interest expense} \times \frac{\text{General limitation assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}}$$

$$\$60{,}000 \times \frac{\$2{,}000{,}000}{(\$100{,}000 + \$900{,}000 + \$2{,}000{,}000)} = \$40{,}000$$

$$\frac{\text{Nonexempt foreign assets}}{\text{20 percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}}$$

To domestic source income:

$$\text{Interest expense} \times \frac{\text{Domestic assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}}$$

$$\$60{,}000 \times \frac{\$100{,}000 + \$900{,}000}{(\$100{,}000 + \$900{,}000 + \$2{,}000{,}000)} = \$20{,}000$$

$$\frac{\text{20 percent of Z stock value} + \text{nonexempt domestic assets}}{\text{20 percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}}$$

Examples 25–29. [Reserved]

Example 30. Income Taxes. (i) (A) *Facts*. As in *Example 17* of this paragraph, X is a domestic corporation that wholly owns M, N, and O, also domestic corporations. X, M, N, and O file a consolidated income tax return. All the income of X and O is from sources within the United States, all of M's income is general limitation income from sources within South America, and all of N's income is general limitation income from sources within Africa. X receives no dividends from M, N, or O. During the taxable year, the consolidated group of corporations earned consolidated gross income of $550,000 and incurred total deductions of $370,000. X has gross income of $100,000 and deductions of $50,000, without regard to its deduction for state income tax. Of the $50,000 of deductions incurred by X, $15,000 relates to X's ownership of M; $10,000 relates to X's ownership of N; $5,000 relates to X's ownership of O; and the entire $30,000 constitutes stewardship expenses. The remainder of X's $20,000 of deductions (which is assumed not to include state income tax) relates to production of U.S. source income from its plant in the United States. M has gross income of $250,000 and deductions of $100,000, which yield foreign-source general limitation taxable income of $150,000. N has gross income of $150,000 and deductions of $200,000, which yield a foreign-source general limitation loss of $50,000. O has gross income of $50,000 and deductions of $20,000, which yield U.S. source taxable income of $30,000.

(B) Unlike *Example 17* of this paragraph (g), however, X also has a deduction of $1,800 for state A income taxes. X's state A taxable income is computed by first making adjustments to the Federal taxable income of X to derive apportionable taxable income for state A tax purposes. An analysis of state A law indicates that state A law also includes in its definition of the taxable business income of X which is apportionable to X's state A activities, the taxable income of M, N, and O, which is related to X's business. As in *Example 25*, the amount of apportionable taxable income attributable to business activities conducted in state A is determined by multiplying apportionable taxable income by a fraction (the ''state apportionment fraction'') that compares the relative amounts of payroll, property, and sales within state A with worldwide payroll, property, and sales. Assuming that X's apportionable taxable income equals $180,000, $100,000 of which is from sources without the United States, and $80,000 is from sources within the United States, and that the state apportionment fraction is equal to 10 percent, X has state A taxable income of $18,000. The state A income tax of $1,800 is then derived by applying the state A income tax rate of 10 percent to the $18,000 of state A taxable income.

(C)(i) *Allocation and apportionment*. Assume that under *Example 29*, it is determined that X's deduction for state A income tax is definitely related to a class of gross income consisting of income from sources both within and without the United States, and that the state A tax is apportioned $1,000 to sources without the United States, and $800 to sources within the United States. Under *Example 17*, without regard to the deduction for X's state A income tax, X has a separate loss of ($25,000) from sources without the United States. After taking into account the deduction for state A income tax, X's separate loss from sources without the United States is increased by the $1,000 state A tax apportioned to sources without the United States, and equals a loss of ($26,000), for purposes of computing the numerator of the consolidated general limitation foreign tax credit limitation.

(h) *Effective dates*—(1) *In general.* In general, the rules of this section, as well as the rules of §§ 1.861–9T, 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–14T apply for taxable years beginning after December 31, 1986, except for paragraphs (a)(5)(ii), (b)(3), (e)(4), (f)(4)(i), and paragraph (g) *Example 17*, *Example 18*, and *Example 30* of this section, which are generally applicable for taxable years beginning after December 31, 2006. Also, see §§ 1.861–8(e)(12)(iv) and 1.861–14(e)(6) for rules concerning the allocation and apportionment of deductions for charitable contributions. In the case of corporate taxpayers, transition rules set forth in § 1.861–13T provide for the gradual phase-in of certain provisions of this and the foregoing sections. However, the following rules are effective for taxable years commencing after December 31, 1988:

(i) Section 1.861–9T(b)(2) (concerning the treatment of certain foreign currency).

(ii) Section 1.861–9T(d)(2) (concerning the treatment of interest incurred by nonresident aliens).

(iii) Section 1.861–10T(b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception).

(iv) Section 1.861–10T(b)(6) (concerning excess collaterilzation of nonrecourse borrowings).

(2) In addition, 1.861–10T(e) (concerning the treatment of related controlled foreign corporation indebtedness) is applicable for taxable years commencing after December 31, 1987. For rules for taxable years beginning before January 1, 1987, and for later years to the extent permitted by 1.861–13T, see 1.861–8 (revised as of April 1, 1986).

(3) *Expiration date.* The applicability of the paragraphs (a)(5)(ii), (b)(3), (e)(4), (f)(4)(i), and paragraph (g) *Example 17*, *Example 18*, and *Example 30* of this section, expires on or before July 31, 2009.

[T.D. 8228, 53 FR 35474, Sept. 14, 1988, as amended by T.D. 8286, 55 FR 3054, Jan. 30, 1990; T.D. 8337, 56 FR 10369, Mar. 12, 1991; T.D.8597, 60 FR 36679, July 18, 1995; T.D. 8805, 64 FR 1509, Jan. 11, 1999; T.D. 8973, 66 FR 67083, Dec. 28, 2001; T.D. 9143, 69 FR 44932, July 28, 2004; T.D. 9211, 70 FR 40663, July 14, 2005; T.D. 9278, 71 FR 44515, Aug. 4, 2006; 71 FR 76903, Dec. 22, 2006]

EDITORIAL NOTE: At 71 FR 76903, Dec. 22, 2006, § 1.861–8T was amended as follows:

2. Paragraph (g), paragraph (i) following *Example 30*. (i)(C) is redesignated as paragraph (ii) and the paragraph designation for *Example 30*. (i)(C) is removed. However, the amendment could not be incorporated because of inaccurate amendatory instructions.

§ 1.861–9 Allocation and apportionment of interest expense.

(a) through (g)(1)(i) [Reserved]. For further guidance, see § 1.861–9T(a) through (g)(1)(i).

(g)(1)(ii) [Reserved]. For further guidance, see the second sentence in § 1.861–9T(g)(1)(ii).

(g)(1)(iii) through (h)(4) [Reserved]. For further guidance, see § 1.861–9T(g)(1)(iii) through (h)(4).

(h)(5) *Characterizing stock in related persons*—(i) *General rule.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under § 1.861–9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904–4(b)).

(ii) *Special rule for section 936 corporations regarding alternative minimum tax.* For purposes of characterizing stock in a related section 936 corporation in determining foreign source alternative